

THE EFFECT OF HUMAN DEVELOPMENT ON FINANCIAL DEVELOPMENT: EVIDENCE FROM INDONESIAN PROVINCES

CHAPTER I INTRODUCTION

1.1 BACKGROUND

The connection between financial development and growth for many years encourage researchers explore about this connection. Some researchers concern to investigate the finance and growth nexus. Some others attempt to investigate the causality effect between finance and growth (Padhran, 2014).

Financial development is also considered as a good predictor of future economic growth, capital accumulation, also technology science (Levine, 1997). Financial development includes both financial intermediaries and financial market. Many papers have suggested that the more developed financial system in a country; it should have a faster economic growth. Going deeper, well-developed financial system could also reduce the corruption levels through well-monitoring function of financial institution (Altunbas, 2012)

The importance of financial development to articulate economic growth drives some researchers to find out the determinant factors of financial development. Herger et al. (2008) investigate the determinants of financial development by putting attention on culture, institution, and trade. One of their finding shows that the firms are typically reluctant to put their fund in the

countries with poor institutional development measured by the level of property right.

Cross-country studies that investigate the connection between financial development and growth show that banking sector is an important component of national growth (Kendall, 2012). So does in Indonesia in which banks play dominant role in the economy (Hamada, 2010).

Indonesian economy put banking sector at important role to boost growth. At the business level, Indonesia has a large number of micro, small and medium enterprises (MSMEs) that need finance through the formal financial institutions, more specifically banking.

To access finance, people or firms need a capability at least minimal capability to understand the term and condition about their finance institution especially in this case products and services of banks. Financial literacy usually indicates the capability to use financial products and services. In this research, I use human development to measure the level of financial literacy. Arguably, the higher the level of human development, it eases people to understand such financial products and services, which in turn improve the financial literacy. Moreover, more educated people typically are not reluctant to adopt new innovation particularly in the financial services.

Therefore, this research focuses to investigate the effect of human development on financial development, especially banking development at provincial level in Indonesia. I also a moderating factor which is the local government characteristic. Aritenang (2008) shows that after decentralization

the disparity between provinces is still severe. Some provinces are still categorized as under-developed provinces. Related to this fact, some researchers argue that banks may avoid to establish their business in under-developed regions (Trinugroho, 2015). Since finance will produce growth, it should be important to make sure that banks as the most dominated financial institutions in Indonesia plays the intermediaries function properly

1.2 RESEARCH QUESTION

According to the background, the research questions are:

1. Does the level of human development improve the level of financial development?
2. Is the impact of human development on financial development stronger in regions having good governance?

1.3 RESEARCH OBJECTIVES

The objectives of this research are to empirically investigate:

1. The effect of Human Development (HD) on financial development at provincial level
2. The moderating effect of regional characteristics on the link between human development and financial development

1.4 RESEARCH CONTRIBUTION

1. To our knowledge, this study will be first to empirically estimate the effect of human development on financial development at provincial level, particularly the effect of human development on banking development
2. This research also tries to provide some policy recommendations to provide better level of quality of life and financial access to escalate the function of financial development, to reach better economic growth and to alleviate inequality